DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 98-0568
INDIANA CORPORATE INCOME TAX
For the 1994, 1995, and 1996 Tax Years

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ISSUES

I. Foreign Currency Rate Exchange Gain.

Authority: I.R.C. § 988; 45 IAC 3.1-1-8; IC 6-3-1-3.5(b).

Taxpayer argues that, for purposes of calculating its adjusted gross income tax liability, it should not be required to include foreign currency exchange rate gain realized by the taxpayer, within the numerator of the sales factor.

II. Applicability of the Throw-Back Rule.

Authority: 45 IAC 3.1-1-53; 45 IAC 3.1-1-64; IC 6-3-1-25; IC 6-3-1-25; IC 6-3-2-2(n)(2); Indiana Dept. of State Revenue v. Continental Steel Corp., 399 N.E.2d 754 (Ind. Ct. App. 1980); Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 112 S.Ct. 2447 (1992); PL 86-272 (15 U.S.C.S. § 381).

Taxpayer argues that, for purposes of calculating its adjusted gross income tax liability, it should not be required to throw-back sales made into Kentucky, Canada, and Japan.

III. Exclusion of Taxpayer's Out-Of-State Tooling from the Property Factor Based on a De Minimis Exception.

Authority: 45 IAC 3.1-1-40; 45 IAC 3.1-1-41

Taxpayer argues that it was error to exclude from the property factor certain out-of-state tooling based upon a purported de minimis exception.

STATEMENT OF FACTS

Taxpayer is a manufacturer of automobile parts, is engaging in a joint venture with a Japanese partner, and is incorporated and headquartered in Indiana. Taxpayer manufactures exhaust systems, instrument panels, door impact beams, and stampings for engine and body parts. Taxpayer sells these parts to automobile manufacturers located in Kentucky, California, Canada, and Japan.

DISCUSSION

I. Foreign Currency Rate Exchange Gain.

Taxpayer makes purchases from foreign vendor. At the time the purchases are made, taxpayer books the accrued liabilities in American dollars. When taxpayer makes the payments, the payments are made in foreign currency. As a result of the delay between accrual of the liabilities and the time payment is made, fluctuations in the foreign currency rate exchange may result in gains or losses. For example, taxpayer purchases $1,000 in goods from foreign vendor and books the $1,000 liability accordingly. By the time taxpayer makes payment in the appropriate foreign currency – and as the result of an intervening exchange rate fluctuation – taxpayer may find that it only needs to make a payment in $900 worth of American currency. Taxpayer protests the decision by audit to include these "gains," realized from the foreign currency rate fluctuations, within the numerator of the sales factor.

Under I.R.C. § 988, a gain or loss attributable to foreign currency exchange fluctuations involving either the sale or purchase of goods, is treated as "ordinary income or loss." I.R.C. § 988(a)(1)(A). When a U.S. taxpayer buys or sells to a foreign company, and the U.S. taxpayer agrees either to pay for the goods – or receive payment for the goods – in foreign currency units, this constitutes a foreign currency transaction from the point of view of the U.S. taxpayer. In these situations, the U.S. taxpayer has "crossed currencies" and has assumed the risk of fluctuating foreign exchange rates of the foreign currency units. This exposed currency risk may lead to recognition of foreign exchange gains or losses in the income of the U.S. taxpayer.

Taxpayer's transactional "gains" are considered "ordinary income or loss" under I.R.C. § 988. Pursuant to 45 IAC 3.1-1-8, Indiana uses the taxpayer's federal adjusted gross income as the starting point for calculating taxpayer's Indiana adjusted gross income. In the absence of any specific authority to deduct taxpayer's foreign currency gains from that federal starting point, audit correctly determined that taxpayer's foreign currency gains are part of Indiana's adjusted gross income tax calculus.

Taxpayer cites to the Department's past practices of treating foreign exchange gains in determining Indiana's gross income tax. However, in determining the taxpayer's *adjusted gross income tax*, the taxpayer's foreign exchange gains are properly included in the numerator of the sales factor. Those foreign exchange gains, included in taxpayer's

federal adjusted gross income, are derived from taxpayer's regular business activities and are properly subject to the apportionment provisions of IC 6-3-1-3.5(b) and, consequently, properly included within the numerator of the sales factor.

FINDING

Taxpayer's protest is respectfully denied.

II. Applicability of the Throw-Back Rule.

The audit determined that taxpayer's activities in Canada, Japan and Kentucky, did not go beyond the protection afforded under PL 86-272 (15 U.S.C.S. § 381). According to the audit, taxpayer's sales to Kentucky should be subject to the throw-back rule because taxpayer did not file tax returns in Kentucky from 1993 through 1995 and because the taxpayer did not have income producing property in Kentucky. The audit determined that taxpayer's sales to Canada should be subject to the throw-back rule because taxpayer does not maintain facilities within Canada and because taxpayer's contact with Canada was limited to sending personnel to address problems arising from one of the taxpayer's products. Similarly, the audit determined that taxpayer's sales to Japan should be subject to the throw-back rule because taxpayer's contact with Japan was limited to personnel visits to their joint-venture partner's headquarters in Japan.

15 U.S.C.S. § 381 (Public Law 86-272) prohibits states from imposing a net income tax on a foreign taxpayer if the foreign taxpayer's only business activity within that state is the solicitation of sales. A state may not impose an income tax on income derived from business activities within that state unless those activities exceed the mere solicitation of sales. 15 U.S.C.S. § 381(a), (c). The effect of the throw-back rule is to revert sales receipts back to the state from where the goods were shipped in those situations where 15 U.S.C.S. § 381 deprives the purchaser's own state of the power to impose a net income tax. 45 IAC 3.1-1-64. In effect, 15 U.S.C.S. § 381 permits Indiana to tax out-of-state business, without violating the Commerce Clause and without the possibility of subjecting taxpayer to double taxation, because Indiana's right to tax those out-of-state activities is derivative of the foreign state's own taxing authority. In every sales transaction, at least one state has the authority to tax income derived from the sale of the tangible personal property; if the state wherein the sale occurred is forbidden to do so by 15 U.S.C.S. § 381, then the income is "thrown-back" to the originating state.

For the purposes of determining whether a taxpayer is subject to the taxing jurisdiction of another state pursuant to 45 IAC 3.1-1-64, "[t]he term 'state' means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof." IC 6-3-1-25. Accordingly, the jurisdictions at issue – Japan, Kentucky, and Canada – fall within the definition of a "state" and are properly considered as potentially subject to the throw-back rule. *See also* IC 6-3-1-25.

Taxpayer disputes audit's determination that its sales to Kentucky, Canada, and Japan should be thrown-back to Indiana. Taxpayer argues that its activities within those foreign jurisdictions exceed the "mere solicitation" 15 U.S.C.S. § 381 standard. Consequently, it is those foreign jurisdictions which have the right to impose the tax – not Indiana.

The Department must determine whether taxpayer's activities within the three foreign jurisdictions exceed the 15 U.S.C.S. § 381 benchmark of "mere solicitation." Indiana Dept. of State Revenue v. Continental Steel Corp., 399 N.E.2d 754 (Ind. Ct. App. 1980), defines those activities which do and do not exceed the "mere solicitation" standard. In that case, the court held that, "solicitation should be limited to those generally accepted or customary acts in the industry which lead to the placing of orders not those which follow as a natural result of the transaction, such as collections, servicing complaints, technical assistance and training . . . ." Id. at 759. Further, "solicitation must be limited to those acts which lead to the placing of orders and does not include those acts which follow as a result of the transaction." Id. The court set out examples of activity which exceeded "mere solicitation" including "giving spot credit, accepting orders, collecting delinquent accounts and picking up returned goods within the taxing state, pooling and exchanging technical personnel in a complex mutual endeavor, maintaining personal property [] and associated local business activity for purposes not related to soliciting orders within the taxing state." Id.

In Continental, the court held that the taxpayer's activities within the foreign state exceeded solicitation because taxpayer's activities "[did] not lead to the placing of orders but follow[ed] as a natural result of transaction." Id. Those activities included the taxpayer's "salesmen making adjustment on complaints, [and] salesmen giving customers technical assistance . . . ." Id.

The "mere solicitation" standard was refined by the Supreme Court in Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 112 S.Ct. 2447 (1992). The Court concluded that "although solicitation covered more than what was strictly essential to making requests for purchases, the fact that an activity is performed by salespersons does not automatically convert that activity into solicitation." Id. at 2456-57. The Court held that whether the taxpayer's in-state activity was sufficiently de minimis to avoid the loss of taxpayer immunity, conferred by 15 U.S.C.S. § 381, depended on whether the activity establishes a "non-trivial additional connection with the taxing State." Id. at 2458. In Wrigley, the Court determined that the taxpayer's sales representatives' activities, consisting of replacing stale gum at retail locations, was an activity outside 15 U.S.C.S. § 381 immunity. Id. at 2458-59. The Court held that although the representatives' activity could be said to facilitate the sales, it did not facilitate the *requesting* of sales and was not ancillary to the solicitation of sales. Id. at 2459 (Emphasis added). Therefore, because taxpayer's practice of having its representatives rotate stocks of stale gum was an activity outside the solicitation of sales, taxpayer brought itself outside the scope of 15 U.S.C.S. § 381 immunity and subjected itself to the local net income tax. Id. at 2460.

Because the taxpayer has submitted separate information relevant to each of the three foreign jurisdictions at issue (Kentucky, Japan, Canada), those three jurisdictions will be addressed separately.

A. Kentucky.

According to the taxpayer, its representatives spend very little of their time marketing products to its Kentucky customer. Taxpayer Letter, Feb. 22, 2001, p. 1. Rather the taxpayer characterizes the relationship between an automobile parts supplier and an automobile manufacturer, in today's "supplier environment," as more complex than the typical relationship between a vendor and an industrial consumer. Taxpayer argues that it maintains an ongoing, day-to-day relationship with its Kentucky customer based upon a collaborative attempt to resolve production, quality, engineering, and sales issues. Taxpayer has submitted quantitative and narrative information in an attempt to describe its relationship to its Kentucky customer.

Four to five times each year, taxpayer's representatives meet with the Kentucky customer for "Data Exchange" sessions. These on-site sessions are conducted for the purpose of acquiring information on taxpayer's performance as a parts supplier. Id. at p. 2. The number of these Data Exchange sessions increases during the introduction of new customer products.

Four times each year, taxpayer's marketing managers, quality control representatives, and purchasing representatives meet with Kentucky customer to perform "Quarterly Reviews" of taxpayer's performance during the preceding quarter. Id. During these on-site Quarterly Reviews, taxpayer's and customer's representatives discuss the customer's quality, cost, and delivery standards.

Once each year, taxpayer's service teams and management meet with Kentucky customer to conduct an "Annual Review" for the purpose of discussing customer's expectations as well as taxpayer's achievements in the areas of cost, quality, and delivery. Id. Between 10 and 20 of taxpayer's employee's attend these meeting. The participants include taxpayer's president, vice-presidents, plant manager, plant coordinator, marketing manager, marketing coordinator, quality control manager, quality control coordinator, production control manager, and production control coordinator.

In addition, taxpayer's production and engineering personnel perform annual, on-site "Production/Engineering Reviews" to discuss production standards, discuss potential quality control problems, and determine means for minimizing those problems. Id.

Taxpayer's quality control personnel visit the Kentucky customer to conduct "Bi-Weekly Quality Control Visits." These visits are conducted for the purpose of identifying potential production problems. Taxpayer's and customer's representatives review new part design and alternative part designs. The representatives review customer's

production problems, discuss delivery of non-conforming parts, evaluate sample parts, investigate warranted return parts, and perform on-site repairs of non-conforming parts.

Taxpayer maintains an on-site quality control team for one week during the time in which its Kentucky customer introduces a new product. Id. at p. 3.

In addition to the above narrative information, taxpayer has submitted quantitative information regarding the number of hours taxpayer's representatives spend at the Kentucky customer site. During the audit period, taxpayer's marketing personnel spent between 250 to 300 hours each year at the Kentucky customer site. During the audit period, taxpayer's quality control personnel spent 400 to 800 hours each year at the Kentucky customer site. During the audit period, taxpayer's production control personnel spent between 100 to 200 hours each year at the Kentucky customer site. Id.

Taxpayer has submitted information sufficient to establish that its Kentucky activities exceed the "mere solicitation" standard of 15 U.S.C.S. § 381, that the taxpayer is subject to Kentucky's net income tax, and that the income derived from taxpayer's Kentucky activities should not be thrown back to Indiana. Taken together, taxpayer's activities within Kentucky constitute a "non-trivial additional connection" with Kentucky over and above the solicitation of its automobile parts business. Wrigley, 112 S.Ct. at 2458. The issue of whether taxpayer does or does not file a Kentucky income tax return, does or does not pay Kentucky income taxes, is irrelevant and is of no concern to the state of Indiana. Continental, 399 N.E.2d at 758; IC 6-3-2-2(n)(2).

B. Canada.

Taxpayer maintains that its relationship with its Canadian customer is similar to the relationship it has with its Kentucky customer. Taxpayer Letter, Feb. 22, 2001, p. 4. Although similar, taxpayer admits that its contacts with its Canadian customer are more limited than those it maintains with its Kentucky customer. Orders for parts destined for Canadian customer do not originate from the Canadian site. Taxpayer does not maintain its own tangible personal property at the Canadian site. Taxpayer does not send its own representatives to Canadian customer for regular quarterly meetings. In contrast to the regularly scheduled contacts taxpayer maintains with its Kentucky customer, taxpayer schedules its visits to Canadian customer – in which it provides services similar to those provided Kentucky customer – as Canadian customer requests.

In an attempt to quantify its contacts with Canadian customer, taxpayer estimates that its personnel, during the relevant 1994 to 1996 tax years, spent 1,700 hours at the Canadian site. During that time, taxpayer was called on to address specific product issues, assist with the receipt of parts, and sort replacement parts. Id.

From the information provided by the taxpayer, taxpayer's representatives performed activities in Canada that exceed the "solicitation of orders." Wrigley, 112 S.Ct. at 2455. Further, taxpayer's Canadian activities exceed the de minimis exception because the

activities establish a "nontrivial additional connect with the taxing [jurisdiction]." Id. at 2458. The taxpayer's specific on-site activities – addressing quality issues, assisting in the receipt of taxpayer's parts, sorting replacement parts – served an "independent business function apart from their connection to the soliciting of orders." Id. at 2456.

Taxpayer has provided sufficient information to establish that its Canadian activities exceed the 15 U.S.C.S. § 381 "mere solicitation" standard, that the taxpayer has subjected itself to the jurisdiction's net income tax, and that the income derived from taxpayer's Canadian activities should not be thrown back to Indiana.

The existence of the Convention Between the United States of America and Canada With Respect to Taxes on Income and on Capital, Sept. 26, 1980, U.S.-Can., T.I.A.S. No. 11087, is an irrelevancy in determining the applicability of the throw-back rule to taxpayer's Canadian business activities. 45 IAC 3.1-1-64 states in relevant part:

> In the case of any "State," as defined in IC 6-3-1-25, other than a state of the United States or political subdivision of such state, the determination of whether [a] "state" [as defined in IC 6-3-1-25] has jurisdiction to subject the taxpayer to a net income tax shall be made by application of the jurisdictional standards applicable to that state of the United States. If jurisdiction to tax is otherwise present, such "state' is not considered as being without jurisdiction to tax by reason of the provisions of a treaty between that state and the United States.

C. Japan.

Taxpayer raises the identical issue with regards to income derived from its activities in Japan. Taxpayer maintains that sales made to its Japanese customer should not be thrown back to Indiana because taxpayer was not the "exporter of record." Taxpayer Letter, Sept. 16, 1998, p. 5. Goods destined for taxpayer's Japanese customer were not shipped by taxpayer but were picked up in the United States and exported to Japan by an independent entity. Id. at 3. Taxpayer maintains that its sales to Japan were classified as "Japanese sales" merely for its own accounting and tax administrative ease. Id. at 5.

Taxpayer makes a distinction without a difference. Taxpayer manufactured auto parts and sold those goods to its Japanese customer. The fact that an independent third-party shipped the goods is an irrelevancy. The regulation is quite clear. 45 IAC 3.1-1-53 provides that gross receipts from the sale of tangible personal property are deemed to be in Indiana "if the property is shipped from an office, store, factory, or other place of storage in this state, and the taxpayer is not taxable in the state of the purchaser."

Since taxpayer has not demonstrated that its Japanese activities exceeded the 15 U.S.C.S. § 381 benchmark, that taxpayer was not subject to the jurisdiction's net income tax, or that its Japanese activities were not merely ancillary to the solicitation of sales, the income derived from taxpayer's Japanese activities is subject to the throw-back rule under 45 IAC 3.1-1-53.

FINDING

Taxpayer's protest is denied in part and sustained in part.

III. Exclusion of Taxpayer's Out-Of-State Tooling from the Property Factor Based on a De Minimis Exception.

Taxpayer maintains certain tangible personal property at its Kentucky customer's manufacturing facility. Taxpayer Letter, Feb. 22, 2001, p. 3. This equipment consists of gauges. The gauges are incorporated into tooling, used by a third-party vendor (sub-contractor), to manufacture integral component parts of the products taxpayer sells to Kentucky customer. The tooling is assigned to third-party vendor to assure that the parts produced by third-party vendor meet taxpayer's quality standards. Taxpayer maintains that this "tooling [gauges] is used to produce a component part of [taxpayer's] business inventory . . . ." Taxpayer Letter, Sept. 16, 1998, p. 6. Taxpayer argues that the tangible personal property should be included in the property factor.

The audit disagreed and reduced "property everywhere" to reflect the value of the tangible personal property. The audit stated that "[t]he vendor tooling is de minimis in value and is not producing income."

45 IAC 3.1-1-41 states that "The property factor includes all property owned or rented by the taxpayer which is actually used or is available for or capable of being used to produce business income." Taxpayer states that the tooling is incorporated into equipment used to produce component automobile parts. Accordingly, the tooling falls within the 45 IAC definition of property used to produce business income. Therefore, the tooling should be included within taxpayer's property factor pursuant to 45 IAC 3.1-1-40 because the tooling is being used to produce business income. The fact that the value of the tooling, approximately $ 67,000, is de minimis in comparison to the value of taxpayer's total property in all states, is irrelevant in reaching that determination.

FINDING

Taxpayer's protest is sustained.